No. 14,732

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC HOMES, INC., a corporation,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal from the United States District Court for the Northern District of California, Southern Division.

REPLY BRIEF FOR APPELLANT.

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Subject Index

Table of Authorities Cited

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A. INTRODUCTORY STATEMENT.

Appellee's position, as set forth in its brief, does not sustain the judgment because it fails to follow, and is directly contradictory to, the undisputed testimony and the following exhibits which are stipulated by the parties to be correct.

Exhibit No.	Subject	
2	Rents received by appellant	(R. 33)
3	Profit from property sales	(R. 34)
5	Summary by months of sales at Homewood	(R. 36)
6	Summary by months of sales at Southwood	(R. 37)
7	Summary by months of sales at Shoreview	(R. 38)

Because of their direct application to the issues in this case, we have set forth exhibits 5, 6 and 7 in the appendix to our opening brief (App. pp. iii, iv, v). We respectfully ask this Court to study each position of each party in the light of those exhibits and the other uncontradicted evidence to be set forth herein. The parties have stipulated to the correctness of the above listed exhibits. Under the circumstances, this Court will draw its own inferences from undisputed facts. *Pacific Portland Cement Co. v. Food Machinery and Chemical Corporation,* 178 Fed. (2d) 541, 548; CA9; 1949; *McGah v. Commissioner,* 210 Fed. (2d) 769, 771; CA9; 1954.

We repeat at this point that the term "houses here in issue" (as in our Opening Brief p. 8), refers only to the 55 houses listed in Column 2 of Exhibit 5 (R. 36), all of the houses in the Southwood Tract (Exhibit 6, R. 37), and all of the houses in the Shoreview Tract (Exhibit 7, R. 38), except the 7 houses in Shoreview Tract which were sold immediately upon construction and prior to the tax years here involved.

B. ARGUMENT.

1. THE FINDINGS DO NOT STATE WHEN AND HOW LONG ANY HOUSES HERE IN ISSUE WERE HELD FOR SALE PRIOR TO THEIR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF TRADE OR BUSINESS.

In order to sustain the judgment, the findings of the trial Court are required to state "when and how long, if at all", the houses were held for sale prior

to their sale to customers in the ordinary course of trade or business. *McGah v. Commissioner,* 193 Fed. (2d) 662, 663; CA9; 1952. To satisfy the rule in the *McGah* case, the trial Court was required to find

(a) Whether the houses were held *primarily for sale to customers in the ordinary course of a trade or business;* and

(b) When and how long, if at all, the houses were so held.

Such findings were not made. If they had been made, they would have been without support in the record.

There are three findings in which the trial Court had a clear opportunity to find *when and how long, if at all,* the houses were held *"for sale to customers in the ordinary course of a trade or business".*

Finding 6 (R. 45) could have declared, but does not declare that the date from which the houses here in issue were held for sale to customers in the ordinary course of trade or business was on or about December 9, 1943.

In Finding 16 (R. 48) the Court found sales to customers in the ordinary course of Appellant's trade or business, but failed to identify when and how long they were held, except to say that it was "prior to the sales in question". Such a finding does not show when or how long they were so held, and was condemned by this Court in *McGah v. Commissioner,* 193 F. (2d) 662, 663; CA9; 1952.

Finding 8 (R. 46) refers to a decision by Appellant to hold all of its houses in Homewood, Southwood and Shoreview *for sale to customers in the ordinary course of trade or business,* but, again, the question of *when and how long they were so held* is avoided. The general reference to "after several months of rental experience" does not relate the decision to any known facts. But when the Court found that "the tract managers were *then* instructed to sell the houses as they became vacant", the Record positively identifies that time as V-E Day, May 10, 1945 (R. 135, 136, 143). But if May 10, 1945 is the date from which Appellant is found to have held its houses for sale, such date nullifies Appellee's argument made throughout its brief (pp. 12, 14) that Appellant held its houses for sale from December 9, 1943.

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2. NEITHER THE FINDINGS NOR THE EVIDENCE SUPPORTS APPELLEE'S CONTENTION THAT THE DATE FROM WHICH THE HOUSES HERE IN ISSUE WERE HELD FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF A TRADE OR BUSINESS WAS ON OR ABOUT DECEMBER 9, 1943.

Recognizing (a) that the findings must fix the date when the houses were held for such sale and, (b), that the findings in our case do not specify such date, Appellee nevertheless asks this Court to accept December 9, 1943, as the date from which Appellant held the houses here in issue for sale to customers in the ordinary course of a trade or business. Appellee (Br. p. 11) refers to Findings 6 and 16 and, then, on page 12, states:

"These findings, together with the Court's opinion, make it clear that the date from which the houses were held for sale was on or about December 9, 1943 (R. 40-41)."

Finding 6 (R. 45) does not so state (see ante, p. 3).

The Opinion (R. 40-41) upon which Appellee relies to support the quoted claim is based on the Directors' resolution of December 9, 1943. We showed in our opening brief (p. 32) that the resolution did not state what Appellee contends is set forth therein. This point will also be covered more fully later in this brief.

Finding 16 (R. 48) relied upon by Appellee, by its terms contains NO reference to the date of December 9, 1943. It does, however, state that the houses here in issue were held primarily for sale "from the time when the decision was made, prior to the sales in question, to sell all houses as they became vacant . . ." The record shows unmistakably that the decision was made on *May 10, 1945,* not December 9, 1943, to sell houses as they became vacant. The testimony of Mr. Chamberlain on cross-examination was (R. 143):

Q. You stated that after some experience it appeared renting these houses was not a profitable business, is that correct?

A. No, it didn't appear to be.

Q. I then take it that sometime in—you said the spring, was it, of 1945, you decided the houses should be sold as they became vacant, is that correct?

A. Yes. Well, it isn't exactly the case, either. We are talking about two different situations. In Pacific Homes the most vivid spot in my recollection is Southwood and seeing some weeds in the front yard, and that is where I decided to sell the houses as they became vacant.

Q. And when did you make that decision?

A. Oh, it was in June or July.

Q. Of what year?

A. Or May, 1945. I think it was right VE Day, which I believe was May 10th.

Q. Well, would you state that after that time, then, the Corporation or you had the intention that the Corporation should hold these houses for sale to customers as the houses became vacant?

A. No, they were held for rent; but the restriction I put on previously that they were not to be sold at all was lifted.

Summarizing, it is clear that none of the 3 sources referred to by Appellee (Br. p. 12) support its claim that the Findings declare that December 9, 1943 is the date from which the houses here in issue were held by Appellant primarily for sale to customers in the ordinary course of its trade or business.

Appellee, at pages 12 and 14 of its brief, urges this Court to construe the findings to mean that Appellant held the houses here in issue for sale to customers from December 9, 1943. The primary, if not the only, evidence to support such a construction of the findings are the minutes of the December 9, 1943 meeting of the Directors which are referred to on

page 13 of Appellee's brief as being ". . . of major importance . . ."

The language of the preamble and the resolution are set forth at pages 154-155 of the Record.

The directors' resolution of December 9, 1943, does not state specifically or indicate by inference an intention to change Appellant's business from a rental operation to holding its houses for sale to customers in the ordinary course of a trade or business.

The actual language of the resolution of December 9, 1943 shows that it is merely formal corporate action appropriate to a business which has had, or may have, *any* sales of real property, such as houses rented subject to purchase options and "Beat up" houses (R. 145). In our opening brief we pointed out that finding 6 (R. 45), misstated the resolution to which it refers (Br. pp. 32-33). Appellee's brief ignores this discrepancy because it has no answer. A reading of our opening brief (pp. 32, 33) in the light of the exhibits giving the rental history shows that no reasonable interpretation of the language used would sustain a contention that the resolution shows an intention to abandon the rental business in favor of holding houses primarily for sale to customers in the ordinary course of a trade or business. This is a matter on which the reviewing Court will draw its own inference. *Pacific Portland Cement Co. v. Food Machinery and Chemical Corporation,* 178 Fed. (2d) 541, 548; CA9; *McGah v. Commissioner,* 210 Fed. (2d) 769, 771; CA9; 1954.

When the subsequent record of renting without a single sale of one of the houses here in issue *for the next fifteen months* is considered (R. 36, 37 and 38), it becomes clear that there is no room for an inference that appellant, by the Director's resolution in December, 1943, thereby changed its entire business merely because it authorized corporate action as to SOME SALES.

With the proper effect given to the directors' resolution of December 9, 1943, appellee's reliance (Br. p. 11) on its construction of findings 6 and 16 is wholly discredited. This is of the utmost importance because unless finding 16 (R. 48) is aided by insertion of a definite date, December 9, 1943, the judgment cannot be sustained. The evidence will not permit such insertion of the date December 9, 1943, because the evidence shows:

(1) Appellant in December, 1943 was completing its Southwood and Shoreview Tracts in accord with its application for priorities to build defense houses for RENT (R. 158, 159):

(2) Appellant in fact rented these units after construction (Finding 5, R. 45);

(3) Appellant did not sell any of the houses in Southwood or *Shoreview Tracts until April, 1945—over 15 months after the date Appellee states Appellant commenced to hold its houses for sale to customers.

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*Excluding the 7 houses sold because of an overpass.

(4) Appellant executed 63 non option leases, 58 of which were 12 month leases in the Homewood Tract, after December 10, 1943 (R. 75).

The uncontradicted evidence refutes Appellee's claim that Appellant after December 9, 1943 held its houses primarily for sale to customers and also effectively disposes of that portion of finding 6 (R. 45) which purports to hold that thereafter Appellant's intention was to pursue whichever activity, renting or selling, proved more profitable.

The fact is that with the houses in the Southwood and Shoreview Tracts leased under 12-month leases commencing in or shortly after December, 1943, *Appellant was in no position to hold any of such houses primarily for sale to customers in the ordinary course of a trade or business.* The fact is that Appellant did not hold such houses for sale at all, let alone hold them *primarily* for sale to customers in the ordinary course of its trade or business. Without the tenants' consents, the houses could not have been delivered to a prospective buyer while under 12-month lease commitments.

This condition is recognized and relied upon by Appellee to explain the *absence* of sales for the 15-month period between January 1, 1944, the approximate date of completion of construction of these houses, and early May, 1945, which is the date the decision to liquidate was made (Br. p. 17).

But this explanation by Appellee is wholly inconsistent with Appellee's claim in another portion of its

brief (p. 14) that *Appellant held its houses for sale from December 9, 1943,* and that its decision to so hold its houses was made at the meeting of the Board of Directors on that day.

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3. THE ACCOUNTANT'S CHARACTERIZATION OF APPELLANT'S BUSINESS ON THE TAX RETURNS IS NOT INCONSISTENT WITH (a) A RENTAL OPERATION AND (b) SUBSEQUENT LIQUIDATION OF HOUSES HELD FOR RENTAL.

Appellee in its brief (p. 13) apparently believes that some inference favorable to Appellee should be drawn from the accountant's characterization of Appellant's business as that of "Development of Subdivision, Renting and Selling Homes to Defense Workers".

The fact is that Appellant (1) Rented houses and (2) Sold houses, for example, to tenant option holders and also houses which were "beat up" (R. 145). Hence the accountant's description was factually accurate.

The income tax numerical designation of Appellant's business by the accountants was classification No. "182". This numerical classification is described in the instructions for preparing corporation returns as applicable to "Owner-operators of improved property and Lessors of buildings" (R. 95, 96).

The accountants reported the gains from the sale of houses as long term or short term capital gains as the case might be. The accountants did not report such

gains as ordinary income as would be the case if the accountants believed that the gains from the sale of houses constituted gains from the sales of property held primarily for sale to customers in the ordinary course of its trade or business. Instead, the accountants reported on line 4 of the income tax returns for each year, the rentals received but not the gains from the sales of houses (R. 90-94; R. 161, 162, 163).

If the choice of words made by the accountants in characterizing the business of Appellant is considered significant in establishing the status of Appellant for tax purposes, (1) the conclusion of the accountants as to the form and method of reporting the gains on the sales of houses as gains from the sales of capital assets is much more significant because such determination involves a direct decision by the accountants on the matter here in issue and (2) the numerical classification of Appellant (No. 182) is of equal significance with the narrative, since No. 182 in the Corporate Income Tax instructions, signifies a corporation engaged in the business of acting as "Owner-operators of improved property and lessors of buildings" (R. 95, 96, 161, 162, 163).

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4. THE REMAINING POINTS MADE IN THE SUMMARY OF ARGUMENT IN APPELLEE'S BRIEF DO NOT SUPPORT THE JUDGMENT.

We believe that all remaining contentions of Appellee are answered by the stipulated exhibits 5, 6 and 7 showing what actually happened with reference to

sales. We again urgently invite this Court's attention to those exhibits (R. 35, 36, 37).

Appellee (Br. p. 8) stresses the point that Appellant adopted a method of doing business which automatically resulted in sales. The above exhibits show that actual sales in each tract of houses here in issue were negligible prior to the decision to liquidate on VE Day, May 10, 1945. As to conditions *after* VE Day, the fact that the sales were automatic proves that Appellant did not enter into the real estate business.

Appellee (Br. p. 8) refers to activity on the part of taxpayer's principal stockholders in similar undertakings which resulted in frequent and numerous sales of houses. This point is based on Finding No. 7 (R. 45) of the trial Court, which relates explicitly and solely to the practice of renting with option to buy. By inference, then, it follows that at the Southwood and Shoreview Tracts, where there were no options to buy (Finding No. 5, R. 45), and at Homewood after the options terminated a different method of doing business was pursued.

Another point made by Appellee (Br. p. 8) is that Appellant announced its intention to sell its houses rather than to rent them if this would result in a greater profit. The fact is that Appellant could sell at a profit, where it did not appear able to rent at a profit (R. 143). Taking a profit or avoiding a loss is generally a major reason for liquidating an investment. As this Court said in *Ehrman v. C.I.R.,* 120 F. (2d) 607; C.A. 9, 1941:

> " . . . We fail to see that the reasons behind a person's entering into a business—whether it is

> to make money or whether it is to liquidate—should be determinative of the question of whether or not the gains resulting from sales are ordinary gains or capital gains . . ." (Page 610).

It is merely a matter of *how* the liquidation is carried out.

Appellee claims that there was sales activity on the part of the employes of the taxpayer *as real estate brokers* (Br. p. 8). We find nothing in the record to suggest that any employes of the taxpayer were real estate brokers, and believe that this is an unintentional error. To the contrary, the record shows that that the final cross-examination of Mr. Chamberlain on this point reads:

> "Q. If I understood you correctly, then, at the time that the decision was made that the houses should be sold as they became vacant, it thereafter was unnecessary to engage in any kind of activity, any kind of active sales campaign, because the houses more or less sold themselves? Would that be a fair statement?
>
> A. I am trying to think of the implication of that. I think that is a fair statement." (R. 146).

Liquidation under such circumstances cannot possibly be considered such an entry into the real estate business as requires ordinary income treatment, *Robert W. Dillon v. Commissioner,* 213 Fed. (2d) 218; C.A., 8; 1954.

Appellee claims (Br. p. 8) that at some unstated time there was a decline in rental income, coupled with a sharp rise in sales income. Taking the two critical dates, December, 1943, and May, 1945, it is

interesting to note for the Southwood Tract the relation of income and rental (R. 33, 34):

Fiscal Year	Net Rent Income	Sales Income
May 31, 1944 (Dec. 1943)	$2,244.47	None
May 31, 1945 (May 10, 1945)	8,429.04	$ 2,354.76
May 31, 1946 (first full year after May 10, 1945)	2,878.74	88,654.24

Instead of rent *declining* after the *supposed* decision to sell in December, 1943, it *increased,* while the sales income remained at nothing. The reduction of rent income coupled with a sharp rise in sales income occurred in the fiscal year following Appellant's decision to liquidate on VE Day, May 10, 1945.

The rent income and sales income at the Shoreview Tract (R. 33, 34) show the same pattern if we exclude the unusual and nonrecurring sales income of $5,147.65 for the year ended May 31, 1944, which was due to the sale of 7 houses immediately upon construction, because of an impending overpass (R. 133).

As we have seen from the stipulated evidence in this case, all houses at Homewood were initially leased with 30-month options to purchase. Plaintiff's Exhibit No. 11 (R. 75) shows that although 419 leases were given on the 212 houses at Homewood, all *option* leases were given on or before December 10, 1943, and commencing December 21, 1943, only *non-option* leases were given. Because of the importance which Appellee attaches to the date of December 9, 1943, we cannot emphasize too strongly that it was only twelve days later that Appellant commenced giving 63 non-option leases at Homewood.

At page 26 of our opening brief, we pointed out that in September, 1944, two years after completion of the Homewood Tract, 203 houses were still on hand. This FACT was stipulated to and Appellee does not challenge it *as a fact.* Appellee does, however, say that a *logical* answer is that the tenants had two and one-half years to exercise their options (Br. p. 16). But this answer of Appellee can apply only to houses which were continuously under lease-option from September, 1942 to September, 1944, and cannot apply to the houses subject to *non-option* leases which are the houses here in issue.

The record shows that 356 *option* leases were given at Homewood on or before December 10, 1943. The record also shows that 63 *non-option* leases were given commencing December 21, 1943 (R. 75). Except in the case of the first non-option lease which was given on December 21, 1943 (R. 75), and one other non-option lease dated February 6, 1944 (R. 71), the record does not show affirmatively when the non-option leases were given commencing December 21, 1943. However, this information is shown by the worksheets of witness James E. Moore which were the basis upon which the summary of the number of option and non-option leases (R. 75) was developed. We believe that these worksheets should be before this Court, and propose to seek permission to place them in evidence.

If tabulated, they will show month by month the commencement dates of the rentals to non-optionees of the 55 houses at Homewood which are here in issue:

Month	Number of Houses Rented
December 1943	1
January, 1944	3
February, 1944	9
March, 1944	9
April, 1944	7
May, 1944	9
June, 1944	7
July, 1944	4
August, 1944	3
September, 1944	1
October, 1944	2
Total	55

Appellee also invites attention to the fact that the houses in the Southwood and Shoreview Tracts were all rented for a 12-month term, and could not be sold during that period. Again, we will request that the worksheets of witness James E. Moore showing when these houses were first leased be admitted in evidence. Photostats of these worksheets have been in the possession of Appellee since many months before the trial. They show the following:

SHOREVIEW	December, 1943	43
	January, 1944	10
	February, 1944	3
	Total	56
SOUTHWOOD	January, 1944	24
	February, 1944	19
	March, 1944	15
	April, 1944	14
	Total	72

C. CONCLUSION.

The uncontradicted evidence shows that, pursuant to applications for priority assistance, Appellant built defense houses for rent and actually rented the houses in a substantial rental operation to and including the decision made on or about VE Day, May 10, 1945, to liquidate the rental operation. The factors inducing the decision to liquidate are set forth in our opening brief (pages 21-24).

After the decision to liquidate, sales of houses were made without the efforts and tactics customary in a real estate operation. Instead, as set forth in Finding 14 (R. 47) the houses were sold without the necessity of engaging in extensive advertising or sales campaigns; the houses, in effect, sold themselves. We are unaware of any case in which the *absence* of a sales campaign and other aggressive selling tactics has been treated as indicating an entry into the trade or business of holding houses primarily for sale to customers. The absence of these factors obviously negatives such an entry into a trade or business.

The facts in our case, insofar as non-option sales are concerned, are clearly distinguishable from the facts in *Rollingwood Corp. v. Commissioner,* 190 Fed. (2d) 263; C.A. 9; 1951, relied upon by Appellant. In the *Rollingwood* case the sales of houses to non-tenants were immediate, frequent and continuous, in that in the first two years of Rollingwood's existence 203 houses were sold to non-tenants out of a total of 256 houses sold. The Court properly observed that such sales to non-tenants constituted "very persuasive evi-

dence of the purpose for which the houses were held". In the *Rollingwood* case there was no long period of rental operation culminating in a decision to liquidate, such as has been established in our case.

The element of frequency and continuity of sales was considered in our opening brief (page 24) and a statistical comparison was made of the number of non-option sales in our case and the *Rollingwood* case, particularly as such sales were related to each fiscal year. We also discussed in our opening brief the method by which Appellant sold the houses here in issue (page 28). Since the filing of our opening brief, the case of *Goldberg v. Commissioner,* 223 Fed. (2d) 709, C.A. 5; decided June 21, 1955, has come to our attention. This case deals with the problem of frequency and continuity of sales, and the question of whether sales of defense houses are to be considered as sales in liquidation of a rental investment, or whether they are to be treated as sales in the ordinary course of a trade or business. The Court used the following language in connection with these matters:

> "The frequency and continuity of sales is also important. If a rental corporation's assets are sold in a single transaction to a single purchaser, it could not be reasonably contended that there was a sale to a customer in the regular course of business. But more often the owner sells his rental properties piecemeal to different individuals. How frequent the sales are depends on many circumstances; the extent to which the seller turns his talents to the promotion and solicitation of sales, the number of units in the rental project, and the

state of the market. Only the first of these circumstances has any rational connection with the question whether the owner has changed his business to selling, or is simply liquidating his business. Thus the frequency and continuity of sales factor is significant only so far as it reasonably justifies the conclusion that the owner somehow promoted the sales. The Courts do not deny capital gain benefits simply because a large number of sales are made in a short period; for if the owner has a large number of houses on a seller's market, it is quite possible that he may sell them continuously without any sales promotion or solicitation. . . ." (223 F. (2d) at page 712).

The facts in our case compel a decision for Appellant.

Dated, San Francisco, California,
October 24, 1955.

Respectfully submitted,
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